Network General Corporation Annual Report

1
9
9
0

Network General

Contents

Network General Corporation is a leading supplier of software-based tools that help troubleshoot and maintain local area networks (LANs).

The Sniffer™ Network Analyzer family, Network General's award-winning product line, allows network managers to "look" into their networks. This enables them to monitor network activity, as well as diagnose and resolve problems more quickly and cost effectively.

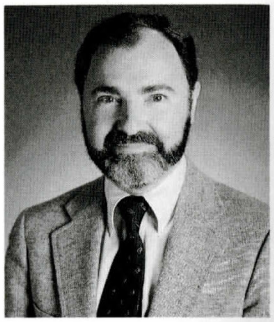
The need for troubleshooting and maintenance tools is becoming increasingly significant in organizations of all sizes. This is due, primarily, to the growing size of LANs, their increasing complexity, their mission-critical nature, and the skyrocketing cost of network slowdowns and failures.

As specialists in the business of LAN analysis, Network General is well positioned to participate in the market's rapid growth. Because the Company provides tools for LANs of all major types, it is uniquely able to serve the needs of a wide variety of organizations.

Letter To Stockholders

The nineteen ninety fiscal year was Network General's first full year as a public company.

It has been an exciting and challenging year for the Company. While we have been adjusting to the demands of being a publicly held business, we have seized the opportunities that come with increased visibility. Ours was one of the year's most successful initial public stock offerings, which allowed us to attract many talented people to fill key positions.



We are pleased with the Company's many successes of the last year. To continue our high level of performance, I believe our primary challenges are to maintain the high quality and timeliness of our product offerings, and, more importantly, to continue taking the steps necessary at all levels of the organization to keep our customers satisfied.

Network General's reputation was built on responsiveness, both on the technical side and in customer service. We intend not only to maintain these commitments, but to expand upon them, as well. An example of this approach is a training program recently launched by Network General in response to customer demand. This training program allows current Sniffer Network Analyzer customers

to realize more value from their units, while giving prospective customers a better understanding of the value of network analysis and monitoring.

Our newly announced product, the Watchdog Network Monitor™, fills the growing gap in the marketplace for an affordable, easy-to-use monitoring tool. For the Company, the Watchdog offering not only represents the addition of a new product, but also introduces Network General to a new market of users.

Another major challenge ahead of us continues to be the area of international market development. Although we have made strides over the year, including opening a subsidiary company in Europe, we intend to assign additional resources toward establishing a greater Network General presence in Europe as well as in the Pacific Rim. In so doing, we hope to provide local promotional and service support for our international distributors, and to convey Network General's commitment to these markets.

With the momentum of fiscal year 1990 propelling us, we look forward to meeting the new challenges and opportunities facing us in the coming fiscal year. We will remain focused on the growing network diagnostics market, and on providing a range of benefit-oriented products with high customer value.

Sincerely,

Dr. Harry J. Saal

President, CEO

Network General's Market Position

Much has been said and written recently about the difficulty of running a network.

A January 30, 1990 article in *PC Magazine* described running a network as the worst job in America, because, "networks are still far too complicated to install and manage." An Arthur D. Little report entitled, "The Computer Network Nightmare...Any Support In A Storm?" examines the lack of support for LAN products by their manufacturers, despite the growing necessity.

Since Network General was founded in 1986, the Company has been committed to providing sophisticated and easy-to-use tools that help take the complexity out of managing a LAN.

Developers are creating new networking products and applications all the time and Network General continues to cooperate with many of them by developing new products to help maintain and troubleshoot their most current product offerings.

In 1990, Network General dedicated significant resources to the development of new products, planned for introduction in the 1991 fiscal year. These products include many enhancements to the Company's award-winning Sniffer line of network analyzers, as well as a network monitor, which meets the growing demand for low-cost tools for LANs of all sizes. This product, the Watchdog Network Monitor, was launched three days after the end of the 1990 fiscal year.

In addition, Network General is developing systems for large, enterprise-wide networks. These systems enable monitoring and analysis of distributed networks from a central location.

Network General's planned new products range from low-cost, stand-alone tools for administrators of small networks, to high-end systems for managers of large, distributed networks that span the globe. These products are being designed to meet the needs of a wide market of network administrators and managers.

1990 was not only a year of new product development, it was also a year of new *market* development. Because networking is a growing, worldwide industry, Network General is committed to developing international markets for analysis and monitoring tools. In March 1990, the Company established a subsidiary company, Network General Europe, in Brussels, Belgium, to serve the European market. The Company is also actively pursuing new business opportunities in the Pacific Rim.

Network General has a strong, leadership position in the network analysis market. The Company believes it can strengthen its position by expanding its presence in the global marketplace, as well as by providing solutions for the low-end of the industry and for high-end users.

*A*n Industry Leader

Network General's products are targeted to three customer segments. The largest of these segments is managers of networks in companies spanning a wide range of industries. The other major segments include LAN service personnel and LAN product developers.

Network General has achieved a leadership position among these customer segments by being the only company dedicated to developing and marketing network analysis products that span the major physical connection technologies and communications protocols. This enables the Company to provide managers and administrators of diverse, multi-vendor computer networks with the comprehensive monitoring and analysis tools needed to keep these systems up and running.

Since homogeneous networks (networks comprised of hardware and software from a single manufacturer) are rarely found in today's large networking environments, Network General has a key competitive advantage in the network analysis market.

Because Network General is an independent supplier of network tools, the Company has been able to establish cooperative relationships with many networking and computer industry leaders, thereby positioning the Company at the forefront of network applications and technology development. Some of these alliances include Microsoft Corporation, Hughes LAN Systems, Sun Microsystems, Apple Computer, Inc., and Banyan Systems, Inc.

A Leading Network Diagnostic Tool

The Sniffer Network Analyzer is the market share leader in its product category. It supports the major LAN hardware and software standards, and offers the benefit of an intuitive, multi-window interface and friendly, English language displays.

As an indicator of the Sniffer analyzer's success, it is used by almost every major computer and networking supplier and developer, as well as by over 40 of the FORTUNE 50 corporations, and many leading education, government, and service organizations. Today, there is an installed base of more than 2,500 Sniffer analyzers worldwide.

Part of the complete family of Sniffer Network Analyzers.

*I*ndustry Awards

Since the introduction of the Sniffer Network Analyzer in 1986, it has earned a number of prestigious awards, as well as rave reviews by critics and users alike. Some of its accolades include:

- "Readers' Choice Award," *LAN Times,* 1990
- "LAN Diagnostic Product of the Year," *LAN Magazine,* 1987, 1988, 1989
- "R&D 100 Award," *Research and Development Magazine,* 1989
- "Editor's Choice," *PC Magazine,* 1987 and 1990

The awards Network General has earned say a great deal about the quality of the Sniffer product. But the awards would be of little value to the Company if the Sniffer analyzer was not also meeting the needs of a growing market.

Network General continually challenges itself to introduce timely, state-of-the-art enhancements to its award-winning product line.

*N*ew Capabilities

As a complement to the sophisticated troubleshooting capabilities of the Sniffer Network Analyzer, Network General recently addressed the need for comprehensive network monitoring. Network monitoring is an essential part of understanding a network's day-to-day performance.

The monitoring capabilities offered by Network General include alarms for network malfunction notification, statistics for performance analysis, and report writing utilities to create management reports on network performance. Together, these features help keep LAN managers and administrators informed and in control of their networks 24 hours a day. In January 1990, these capabilities were introduced as an added set of features to the Sniffer analyzer, and in April 1990, they were introduced in a low-cost, stand-alone product, called the Watchdog Network Monitor.

In addition to these announcements, Network General has introduced a number of enhancements to the Sniffer product family, including support for new protocols and new computer platforms, and new integration capabilities. The Company also introduced an innovative express rental program which enables companies to receive next-day delivery of a Sniffer analyzer during a LAN emergency.

The Growing Market For LAN Analyzers

Two important networking trends are having a significant impact on the LAN analysis market's growth.

First, heterogeneous LANs (those comprising a combination of hardware and software from various vendors) are becoming the rule, rather than the exception. These LANs can be substantially more difficult to maintain than single-vendor LANs, because they require a diversity of knowledge on the part of network managers, and because faults in heterogeneous LANs can be more frequent and harder to detect.

Second, mission-critical applications are migrating from minicomputers and mainframes to local area networks, thereby making LAN security and overall LAN health essential.

Market Awareness

Network users are faced with a variety of problems, issues and complexities involved in network integration and growth. They also must consider expansions into new, advanced technologies, as well as the maintenance and performance optimization of their networks. Network General believes it is essential for companies to be equipped to respond to these challenges, in order to realize the productivity promises of seamless, transparent networked communications.

Network General has sought to educate the marketplace to these issues. The Company has instituted training programs that support current users of Network General products, as well as programs aimed at educating the marketplace in general.

*F*iscal Year 1990 Business Highlights

Fiscal Year 1990 was a year of growth and change for Network General. In addition to adding many new, key employees and moving to larger facilities, we introduced enhancements to our product line. 1990's achievements include the following:

April 6, 1989:
Laurence R. Hootnick, senior vice president of Intel Corporation, and Gregory M. Gallo, an attorney and member of Ware & Freidenrich, were appointed to Network General's Board of Directors.

April 25, 1989:
Network General held its first user group meeting, called Sniffcon-I, to help Sniffer Network Analyzer users better understand LAN protocols, performance and expansion. It provided an excellent forum for users to share their knowledge and learn new methods for optimizing their networks' capabilities.

May 12, 1989:
The Sniffer family of network analyzers was added to the federal government's GSA Schedule, enabling government users to order Sniffer products at discounted prices, and bypass the time-consuming Request For Proposal (RFP) process.

June 12, 1989:
Network General introduced a Sniffer Network Analyzer for Apple Computer's LocalTalk network. It supports the full range of AppleTalk protocols, enabling users to facilitate the incorporation of Macintoshes® into corporate networks built around IBM® and DEC® systems.

June 19, 1989:
Network General announced several changes in senior level management. Roger Ferguson was promoted to chief operating officer. Morey Schapira was promoted to vice president of sales. George Comstock moved from vice president of sales and marketing to vice president of business development. Jay Weil joined the Company as director of marketing.

July 31,1989:
Network General teamed with Apple Computer to develop a Sniffer Network Analyzer for LocalTalk/ Ethernet integration.

September 12, 1989:
Network General unveiled a study, entitled "The Cost Of LAN Downtime," showing the significant impact of network downtime on FORTUNE 1000 corporations.

September 21, 1989:
Network General introduced "Sniffer Express," a rental program designed to provide network users with overnight access to a Sniffer Network Analyzer when a LAN disaster strikes.

September 26, 1989:
Sniffer Version 2.3 was released, enhancing Network General's support of various network protocols, and extending the maximum number of network node addresses available. With this enhancement it also became possible for the Sniffer analyzer to isolate protocol problems within bridges and routers.

September 28, 1989:
The Laptop Sniffer analyzer was the winner of the R&D 100 Award from *Research and Development Magazine*.

October 2, 1989:
Network General introduced the SniffMaster™ I system, a software package that allows distributed LAN analysis using multiple Sniffer analyzers from a central console. The software runs on a Sun Microsystems SunNet™ Manager workstation.

November 6, 1989:
Network General announced a licensing agreement with Digital Equipment Corporation for Digital's LAT protocol specification, extending the Company's diagnostic tools for VAX networks.

November 20, 1989:
Due to steady growth, Network General moved its corporate headquarters to a larger facility, more than triple the size of the Company's previous site.

January 30, 1990:
Network General announced advanced monitoring capabilities for the Ethernet Sniffer Network Analyzer, making it the most extensive protocol analysis and alarm mechanism available, and the only integrated report generation system for network professionals.

March 5, 1990:
Toshiba T3200SX portable computers were offered as new platforms for the 300 Series Laptop Sniffer network analyzer. The more powerful platform offers greater performance and the advantages of the 80386 architecture versus the 80286-based T3200 model it replaced.

March 12, 1990:
Network General Europe, S.A., was formed, and Tom Orr was appointed its vice president of sales. Network General Europe, located in Brussels, Belgium, was initially staffed to provide sales and service support for Network General's European distributors.

April 3, 1990:
Network General introduced the Watchdog Network Monitor.

Results of Operations

The Company has experienced substantial growth in revenues since product shipments began in September 1986. Results for successive quarters reflect the increasing market acceptance of the Company's products and expansion of the Company's marketing and sales efforts. Substantially all of the Company's revenues to date have been derived from the sale of LAN analysis products. New product and service introductions in early fiscal year 1991 may result in changes in the composition of revenues as network monitoring products and training courses comprise a larger portion of the Company's revenues.

Fiscal 1988 revenues were approximately nine times fiscal 1987 revenues. Fiscal 1989 revenues were almost three times fiscal 1988 revenues. Fiscal 1990 revenues were more than two times fiscal 1989 revenues. As a consequence, year to year comparisons of costs and expenses are not considered meaningful because of the vastly different levels of operations. Also, because the level of activity of the Company's operations was significantly lower in fiscal year 1988 than in each of fiscal years 1989 and 1990, the Company believes that a discussion of operations in fiscal year 1988 is not meaningful. Accordingly, the following discussion addresses the eight quarters ended March 31, 1990.

The tables on the opposite page set forth certain quarterly financial information for the last two fiscal years. This information is derived from unaudited financial statements which include, in the opinion of management, all normal, recurring adjustments which management considers necessary for a fair statement of the results for such periods. The operating results for any quarter are not necessarily indicative of results for any future period.

Over the past eight quarters ended March 31, 1990, sales of the Company's products have increased by 240%. Sales for the quarter ended March 31, 1990 were 119% greater than sales for the quarter ended March 31, 1989. However, the Company does not expect to sustain these rates of growth in the future. Increases in sales from quarter to quarter have varied considerably. Over the last eight quarters ended March 31, 1990, quarterly sales increases have ranged from 36.9% to 9.2%.

Sales to international distributors accounted for 19%, 16% and 22% of revenues in fiscal 1990, 1989 and 1988, respectively. The Company established an international sales office in Brussels, Belgium in late fiscal 1990, enabling the Company to expand its support of European sales.

Quarterly Financial Data

Three months ended (in thousands, except per share data)	June 30, 1988	Sept. 30, 1988	Dec. 31, 1988	March 31, 1989	June 30, 1989	Sept. 30 1989	Dec. 31, 1989	March 31, 1990
Revenues	$ 2,582	$ 2,891	$ 3,381	$ 4,010	$ 5,490	$7,120	$ 8,037	$8,774
Cost of Revenues	549	614	875	1,046	1,436	1,892	2,071	1,995
Gross profit	2,033	2,277	2,506	2,964	4,054	5,228	5,966	6,779
Operating Expenses:								
Marketing and sales	733	943	1,033	1,201	1,731	2,361	2,569	3,222
Research and development	175	208	248	276	347	421	533	572
General and administrative	202	192	230	343	406	515	548	630
Income from operations	923	934	995	1,144	1,570	1,931	2,316	2,355
Interest Income, net	36	40	36	162	268	369	453	340
Income before taxes	959	974	1,031	1,306	1,838	2,300	2,769	2,695
Provision for Income Taxes	383	389	413	522	735	888	1,084	983
Net income	$ 576	$ 585	$ 618	$ 784	$ 1,103	$ 1,412	$ 1,685	$1,712
Earnings per share	$ 0.12	$ 0.12	$ 0.13	$ 0.14	$ 0.18	$ 0.21	$ 0.23	$ 0.24
Weighted Average Shares Outstanding	4,847	4,847	4,847	5,619	6,249	6,810	7,202	7,228

As A Percentage Of Revenues

Revenues	100%	100%	100%	100%	100%	100%	100%	100%
Cost of Revenues	21%	21%	26%	26%	26%	27%	26%	23%
Gross profit	79%	79%	74%	74%	74%	73%	74%	77%
Operating Expenses:								
Marketing and sales	28%	33%	31%	30%	32%	33%	32%	37%
Research and development	7%	7%	7%	7%	6%	6%	7%	7%
General and administrative	8%	7%	7%	9%	7%	7%	7%	7%
Income from operations	36%	32%	29%	29%	29%	27%	29%	27%
Interest Income, net	1%	1%	1%	4%	5%	5%	6%	4%
Income before taxes	37%	34%	31%	33%	33%	32%	34%	31%
Provision for Income Taxes	15%	13%	12%	13%	13%	12%	13%	11%
Net income	22%	20%	18%	20%	20%	20%	21%	20%

Cost of revenues consists of manufacturing costs and warranty expenses. Gross profit varies from quarter to quarter due to factors including changes in the relative proportions of international, domestic and OEM sales, changes in product mix and product configuration, new product introductions and price changes. During the eight quarters ended March 31, 1990, gross profit varied from 79% to 73% of revenues. The decline in gross profit for the quarters after September 30, 1988 was due primarily to significant increases in sales of the Company's Series 300 and 500 products combined with a significant decrease in sales of its older Series 400 products, which have been discontinued. The Series 300 and 500 products generally produce lower gross profits than did the Series 400 products. The increase in gross profit for the quarter ended March 31, 1990 reflects an increase in international sales for the quarter. International sales are almost exclusively module-level products, which have a higher gross profit. As new products are introduced during fiscal year 1991, gross profit may change to reflect the varying gross profit contributions of these new products.

The Company's marketing and sales expenses have increased as a percentage of revenues over the last eight fiscal quarters, from 28% in the first quarter of fiscal 1989 to 37% in the fourth quarter of fiscal 1990. This increase was largely the result of significantly increased marketing expenditures, including those for advertising, collateral materials, trade shows, sales training and sales promotions, and increased compensation expenses due to expansion of the marketing and sales staff. Marketing and sales expenses as a percentage of revenues have varied and may vary in the future as a result of changes in the mix of domestic and international sales, since the Company incurs higher sales commission expense on domestic sales. The increase in marketing and sales expenses for the quarter ended March 31, 1990 largely reflects expenses related to the introduction of new products and services, including the Watchdog Network Monitor and Network General training courses. Marketing and sales expenses related to these new products and services are expected to remain significant as a percentage of revenues until related volume sales are achieved.

The Company believes that continued commitment to research and development is required to remain competitive. Research and development expenses consist primarily of salaries and benefits, occupancy expenses, fees paid to outside consultants, and selected expenses related to the acquisition of new technologies. During the eight quarters ended March 31, 1990, research and development expenses increased 227%, but have remained relatively constant as a percentage of revenues, due to the significant growth in revenues. The Company anticipates that salaries and benefits for research and development will continue to increase.

Research and development expenses are accounted for in accordance with FASB Statement No. 86, under which the Company is required to capitalize software development costs after technological feasibility is established. Capitalizable software development costs incurred to date have not been significant and, thus, the Company has charged all software development costs to expense in the consolidated statements of operations.

General and administrative expenses consist primarily of salaries and benefits, occupancy expenses, legal and accounting fees, and fees paid to outside consultants. General and administrative expenses have remained relatively constant as a percentage of revenue during the last eight quarters ended March 31, 1990, while growing by 212% in absolute dollars.

Earnings on the invested proceeds from the initial public offering of Common Stock and the secondary offering of Common Stock have significantly increased net interest income since the quarter ended March 31, 1989. Interest income has declined as a percentage of revenue in the quarter ended March 31, 1990 as interest rates fluctuated and the Company increased its investments in tax free investment instruments.

The Company accrued provisions for income taxes of 40% of income before income taxes for fiscal 1989 and 38.4% of income before income taxes for fiscal 1990. The decrease reflects the results of investing in tax free investments and the tax benefits derived from its Foreign Sales Corporation.

*L*iquidity and Capital Resources

The Company generated positive cash flow in each of the three years ended March 31, 1990. Net cash provided by operating activities were $4.6 million, $1.2 million and $1.0 million in fiscal years 1990, 1989 and 1988, respectively. The net increases between years is mainly the result of higher operating income.

The Company increased its cash flows from investing activities by $3.6 million in fiscal 1990 and used $10.8 million and $1.6 million in fiscal 1989 and 1988, . respectively, to participate in investing activities. The majority of the increase in fiscal 1990 is due to a net increase of $6.6 million in investments in tax free instruments and money market funds with maturities of three months or less. This increase was partially offset by capital expenditures of $3.1 million in fiscal 1990. In fiscal 1989 and 1988, the Company used $10.1 million and $1.5 million, respectively, to invest in certificates of deposit and treasury bills with maturities greater than three months. The Company increased its cash from financing activites by $12.1 million, $9.7 million and $2.0 million in fiscal 1990, 1989 and 1988, respectively. These increases are attributable to proceeds from the secondary offering of common stock in August 1989 ($11.9 million), the initial public offering of common stock in February 1989 ($9.7 million) and the sale of $2.0 million of convertible preferred stock in fiscal 1988.

As of March 31, 1990, the Company's principal source of liquidity included cash and investments of approximately $26.7 million. The Company currently has no borrowings and has no established bank lines of credit. The amount of the Company's capital commitments through fiscal 1991 is not material. The Company believes that current cash investments, together with existing sources of liquidity and anticipated funds from operations, will satisfy the Company's projected working capital and capital expenditure requirements at least through fiscal 1991.

*S*elected Financial Data

CONSOLIDATED STATEMENT OF OPERATIONS DATA:

(Dollars in thousands, except per share data)	Year Ended March 31 1990	1989	1988	Inception (May 15, 1986) to March 31 1987
REVENUES	$ 29,421	$ 12,864	$ 4,911	$ 556
INCOME FROM OPERATIONS	$ 8,172	$ 3,996	$ 1,427	$ 2
NET INCOME	$ 5,912	$ 2,563	$ 832	$ -
EARNINGS PER SHARE	$ .86	$ .51	$ .21	$ -
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING	6,852,000	5,037,000	3,903,000	3,276,000

*N*etwork

General

Corporation

1
9
9
0

CONSOLIDATED BALANCE SHEET DATA:

(Dollars in thousands)	March 31 1990	1989	1988	1987
WORKING CAPITAL	$ 30,235	$ 14,378	$ 2,663	$ (26)
TOTAL ASSETS	$ 36,658	$ 16,959	$ 4,514	$ 341
LONG -TERM OBLIGATIONS AND REDEEMABLE PREFERRED STOCK	$ 62	$ 77	$ 2,043	$ 25
TOTAL SHAREHOLDERS' EQUITY	$ 33,108	$ 15,070	$ 2,829	$ 10

TOTAL EMPLOYEES AT YEAR-END	82	39	15	5

Report of Independent Public Accountants

To Network General Corporation:

We have audited the accompanying consolidated balance sheets of Network General Corporation (a Delaware corporation) and subsidiaries as of March 31, 1990 and 1989, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended March 31, 1990. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Network General Corporation and subsidiaries as of March 31, 1990 and 1989, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 1990 in conformity with generally accepted accounting principles.

Arthur Andersen & Co.

San Jose, California
April 23, 1990

Consolidated Balance Sheets

March 31, 1990 and 1989

(Dollars in thousands, except per share amounts)	March 31 1990	1989
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 21,722	$ 1,456
Cash investments	5,000	11,551
Accounts receivable, net of allowance for doubtful accounts of $183 and $98 in 1990 and 1989, respectively	5,088	2,127
Inventories	1,256	734
Prepaid expenses and deposits	657	322
Total current assets	33,723	16,190
PROPERTY AND EQUIPMENT, at cost:		
Demonstration and rental equipment	1,645	782
Office and development equipment	1,917	236
Leasehold improvements	335	—
Less — Accumulated depreciation and amortization	(1,147)	(265)
Net property and equipment	2,750	753
OTHER ASSETS, net	185	16
	$ 36,658	$ 16,959
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$ 1,155	$ 497
Accrued liabilities	1,834	867
Income taxes payable	352	345
Customer deposits	147	103
Total current liabilities	3,488	1,812
LONG-TERM CUSTOMER DEPOSITS	62	77
COMMITMENTS (Note 4)		
STOCKHOLDERS' EQUITY:		
Preferred stock — $.01 par value		
Authorized — 1,907,171 shares		
Outstanding — none	—	—
Common stock — $.01 par value		
Authorized — 10,000,000 shares		
Outstanding — 7,075,366 shares in 1990 and 6,199,829 shares in 1989	70	62
Additional paid-in-capital	23,755	11,637
Retained earnings	9,283	3,371
Total stockholders' equity	33,108	15,070
	$ 36,658	$ 16,959

The accompanying notes are an integral part of these consolidated balance sheets.

Consolidated Statements of Operations

For the three years ended March 31, 1990

(Dollars in thousands, except per share amounts)	Year Ended March 31 1990	1989	1988
REVENUES	$ 29,421	$ 12,864	$ 4,911
COST OF REVENUES	7,394	3,084	1,128
Gross profit	22,027	9,780	3,783
OPERATING EXPENSES:			
Marketing and sales	9,883	3,910	1,302
Research and development	1,873	907	365
General and administrative	2,099	967	689
Total operating expenses	13,855	5,784	2,356
Income from operations	8,172	3,996	1,427
INTEREST INCOME, NET	1,430	274	33
Income before provision for income taxes	9,602	4,270	1,460
PROVISION FOR INCOME TAXES	3,690	1,707	628
NET INCOME	$ 5,912	$ 2,563	$ 832
EARNINGS PER SHARE	$ .86	$ .51	$ .21
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES OUTSTANDING	6,852,000	5,037,000	3,903,000

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Stockholders' Equity

For the three years ended March 31, 1990

(Dollars in thousands, except per share amounts)	Common Stock Shares	Common Stock Amount	Additional Paid-in Capital	Notes Receivable from Sale of Stock	Retained Earnings	Total
BALANCE, MARCH 31, 1987	3,579,000	$ 12	$ —	$ (2)	$ —	$ 10
Change in par value to $.01 per share upon reincorporation from California to Delaware	—	24	—	—	(24)	—
Exercise of stock options at $.10 per share	175,000	1	16	—	—	17
Collections on notes receivable from sale of stock	—	—	—	2	—	2
Net income	—	—	—	—	832	832
BALANCE, MARCH 31, 1988	3,754,000	37	16	—	808	861
Initial public offering of common stock at $8.00 per share, net of issuance costs of $1,146	1,353,000	14	9,664	—	—	9,678
Conversion of mandatorily redeemable preferred stock into common stock	1,092,829	11	1,957	—	—	1,968
Net income	—	—	—	—	2,563	2,563
BALANCE, MARCH 31, 1989	6,199,829	62	11,637	—	3,371	15,070
Public offering of common stock at $15.25 per share, net of issuance costs of $949	840,500	8	11,861	—	—	11,869
Issuance of common stock under the Employee Stock Purchase Plan at $6.80 and $11.05 per share	12,292	—	108	—	—	108
Issuance of common stock for services rendered	20,910	—	134	—	—	134
Exercise of stock options at $8.00 per share	1,835	—	15	—	—	15
Net income	—	—	—	—	5,912	5,912
BALANCE, MARCH 31, 1990	7,075,366	$ 70	$ 23,755	$ —	$ 9,283	$ 33,108

The accompanying notes are an integral part of these consolidated financial statements.

Consolidated Statements of Cash Flows

For the three years ended March 31, 1990

(Dollars in thousands)	Year Ended March 31 1990	1989	1988
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 5,912	$ 2,563	$ 832
Adjustments to reconcile net income to net cash provided by operating activities—			
Depreciation and amortization	1,029	285	56
Provision for doubtful accounts	136	70	38
(Increase) decrease in assets—			
Accounts receivable	(3,097)	(1,160)	(863)
Inventories	(522)	(495)	(203)
Prepaid expense and deposits	(335)	(188)	(134)
Other assets	(169)	2	1
Increase (decrease) in liabilities—			
Accounts payable and accrued liabilities	1,625	539	539
Income taxes payable	7	(392)	736
Net cash provided by operating activities	4,586	1,224	1,002
CASH FLOWS FROM INVESTING ACTIVITIES			
Proceeds from customer deposits	29	57	98
Purchase of property and equipment	(3,138)	(831)	(236)
Sale of rental equipment	112	—	—
(Increase) decrease in cash investments	6,551	(10,051)	(1,500)
Net cash (used in) provided by investing activities	3,554	(10,825)	(1,638)
CASH FLOWS FROM FINANCING ACTIVITIES			
Proceeds from issuance of preferred stock	—	—	1,968
Proceeds from issuance of common stock, net of issuance costs	12,126	9,678	18
Repayment of notes payable to officers	—	—	(20)
Collection on notes receivable from sale of stock	—	—	2
Net cash provided by financing activities	12,126	9,678	1,968
Net increase in cash and cash equivalents	20,266	77	1,332
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	1,456	1,379	47
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$ 21,722	$ 1,456	$ 1,379

The accompanying notes are an integral part of these consolidated financial statements.

1. OPERATIONS:

Network General Corporation (the "Company") designs, markets and supports software-based LAN analysis tools for a broad spectrum of physical connection technologies and communications protocols. The Company was incorporated in 1986 as a California corporation and changed its state of incorporation to Delaware in fiscal 1988.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Consolidation

The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, after elimination of intercompany accounts and transactions.

Revenues

The Company recognizes product revenues upon shipment of the systems or software. Revenues on rental units and service agreements are recognized ratably over the term of the rental or service period. Royalty income is recognized based on the number of copies of software sold by the licensees of the software products. Revenues on software development contracts with certain OEM customers are recognized based on milestones specified in the contracts. Total revenues from rental units, service agreements, royalties and software development contracts approximated $1,399,000, $943,000 and $230,000 for fiscal 1990, 1989 and 1988, respectively.

No single customer accounted for more than 10% of revenues in fiscal 1990, 1989 or 1988. Export sales, mainly to Europe and Japan, accounted for approximately 19%, 16% and 22% of revenues in 1990, 1989 and 1988, respectively.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, the Company includes cash in banks and cash investments with a maturity of three months or less to be cash equivalents. Cash investments consist of certificates of deposit with maturities of greater than three months, debt obligations of federal, state and municipal governments and related organizations as well as high-grade commercial debt instruments.

The Company paid approximately $3,844,000, $2,229,000 and $12,000 in income taxes in fiscal 1990, 1989 and 1988, respectively (see Note 8). Amounts paid for interest were insignificant.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and related manufacturing overhead. Inventories consist of (in thousands):

	March 31	
	1990	1989
Purchased parts	$ 872	$ 598
Work-in-process	228	124
Finished goods	156	12
	$1,256	$ 734

Property and Equipment

Property and equipment are depreciated and/or amortized using the straight-line method over the following estimated useful lives:

Classification	Life
Demonstration and rental equipment	1-2 years
Office and development equipment	3 years
Leasehold improvements	Lease term

Software Development Costs

The Company anticipates capitalizing eligible computer software development costs upon the establishment of technological feasibility, which the Company has defined as completion of a working model. As of March 31, 1990 and 1989, such capitalizable costs were insignificant and, thus, the Company has charged all software development costs to expense in the accompanying statements of operations.

Earnings Per Share

Earnings per share is computed using the weighted average number of shares of common and common equivalent shares resulting from dilutive convertible preferred stock and options outstanding during the applicable periods. Fully diluted earnings per share is the same as primary earnings per share.

3. ACCRUED LIABILITIES:

Accrued liabilities consist of the following (in thousands):

	March 31, 1990	1989
Accrued compensation and related taxes	$ 630	$ 278
Accrued commissions	680	437
Other accrued expenses	524	152
	$1,834	$ 867

4. COMMITMENTS:

The Company leased certain equipment under operating lease agreements during fiscal 1990, 1989 and 1988 from a company that is wholly owned by two officers and shareholders of the Company. During fiscal 1990 the Company purchased the remainder of the equipment under lease for approximately $77,000. Payments of approximately $185,000, $134,000 and $107,000 were paid to this leasing company in fiscal 1990, 1989 and 1988, respectively. The Company also leases its facilities and certain other equipment under operating lease agreements. As of March 31, 1990, minimum future lease payments under these operating leases are as follows (in thousands):

Fiscal Year	
1991	$ 538
1992	732
1993	80
1994	9
1995	—
	$1,359

Total rent expense was approximately $359,000, $285,000 and $127,000 in fiscal 1990, 1989 and 1988, respectively.

5. CASH BONUS:

The Company has established a discretionary cash bonus plan for its employees. The amounts and individuals to be awarded the bonus are based on the achievement of certain performance goals for the Company and the individual, as approved by the Board of Directors. The Company recorded bonus expense of approximately $813,000, $427,000 and $180,000 in fiscal 1990, 1989 and 1988, respectively.

6. EMPLOYEE SAVINGS PLAN:

In September 1988, the Board of Directors approved an employee savings plan (the "Plan") which is intended to be qualified and exempt from tax under section 401(K) of the Internal Revenue Code. Under the Plan, employees may elect to contribute up to 15% of their gross compensation. The Company contributes to the Plan in amounts determined at the discretion of the Board of Directors. All contributions by the Company are funded currently and vest ratably over three years. All employee contributions are fully vested. Amounts provided by the Company under the Plan to date have not been material.

7. COMMON STOCK:

The Company consummated an initial public offering of its common stock at $8.00 per share in February 1989. In connection with this offering, all mandatorily redeemable preferred stock outstanding at that time was converted into common stock on a one for one basis.

In August 1989, the Company completed a secondary public offering of its common stock at $15.25 per share.

STOCK OPTION PLANS.

Under the Company's 1989 Stock Option Plan, key employees, employee directors and consultants may be granted either incentive or non-qualified options to purchase common stock at the discretion of the Board of Directors. Initially, the Company authorized the issuance of 250,000 shares under this plan.

In fiscal 1990, the Company authorized an additional 500,000 shares for issuance under this Plan. The additional 500,000 shares are subject to the approval of the Company's stock-holders. The exercise price of the stock options may not be less than the fair market value of the common stock on the date of the grant for incentive options or less than 85% of the fair market value of the common stock on the date of grant for non-qualified options. Generally, all options either vest ratably over a three year period or in a lump sum amount at the end of four years.

Option activity under the plan since inception is summarized as follows:

	Available for Grant	Outstanding	Price
Authorized	250,000	--	--
Granted	(86,000)	86,000	$8.00-10.18
Balance at March 31, 1989	164,000	86,000	$8.00-10.18
Authorized	500,000	--	--
Granted	(209,400)	209,400	$11.87-22.25
Cancelled	7,000	(7,000)	$8.00-11.87
Exercised	--	(1,835)	$8.00
Balance at March 31, 1990	461,600	286,565	$8.00-22.25

Of the oustanding options, 24,998 options were exercisable as of March 31, 1990. No options were exercisable as of March 31, 1989.

In April 1989, the Company established the 1989 Outside Directors Stock Option Plan, whereby outside directors may be granted non-qualified options to purchase common stock. 180,000 shares of common stock were reserved for issuance under this plan. The exercise price of the stock option may not be less than the fair market value of the common stock on the date of the grant. Generally, all options vest over a three year period.

Each outside director is granted an option of 30,000 shares upon election to the Board and an additional 5,000 shares each subsequent year. As of March 31, 1990, 90,000 options have been granted and were outstanding at $10.50 per share.

STOCK PURCHASE PLAN.

The Company has reserved 150,000 shares of common stock for issuance under the 1989 Employee Stock Purchase Plan. Employees may elect to withhold up to 10% of their compensation for the purchase of the Company's common stock. The amounts withheld are used to purchase the Company's common stock at a price equal to 85% of the fair market value of the stock on the first or last day of a six-month offering period, whichever is lower.

During fiscal 1990, the Company issued 12,292 shares of common stock under the plan at prices of $6.80 and $11.05 per share.

STOCK AWARD PLAN.

In June 1989, the Board of Directors approved the 1989 Common Stock Award Plan and reserved 60,000 shares for issuance thereunder. Under this plan, awards are made to independent sales representatives and consultants based upon individual sales performance criteria. The shares are issued at fair market value and the related costs of the shares are charged to expenses. The shares generally vest over three years and the Company can reacquire any unvested shares upon termination of the individual's relationship with the Company. As of March 31, 1990, 8,910 shares have been awarded under this Plan.

As of March 31, 1990, the Company has the following shares of common stock reserved for future issuance:

1989 Stock Option Plan	748,165
1989 Outside Directors Stock Option Plan	180,000
1989 Stock Purchase Plan	137,708
1989 Stock Award Plan	51,090
	1,116,963

8. INCOME TAXES:

The Company has elected early implementation of the provision of the Statement of Financial Accounting Standards No. 96 "Accounting For Income Taxes" for fiscal 1990, 1989 and 1988 in these financial statements. The components of the provision for income taxes for fiscal 1990, 1989 and 1988 consisted of the following (in thousands):

	1990	1989	1988
Federal—			
Current payable	$ 2,900	$ 1,440	$ 594
Deferred asset	(128)	(138)	(120)
	2,772	1,302	474
State—			
Current payable	918	405	154
	$ 3,690	$ 1,707	$ 628

The sources of deferred tax assets are as follows (in thousands):

	1990	1989	1988
Reserves and accruals not currently deductible for tax purposes	$ 112	$ 28	$ 51
State taxes, not currently deductible for Federal tax purposes	174	81	57
Depreciation	(167)	--	8
Other	9	29	4
	$ 128	$ 138	$ 120

The following is a reconciliation of the effective income tax rate for financial statement purposes to the United States statutory Federal income tax rate for fiscal 1990, 1989 and 1988:

	1990	1989	1988
Statutory Federal income tax rate	34.0%	34.0%	37.0%
State income taxes, net of Federal benefit	6.6	5.8	5.9
Other	(2.2)	0.2	0.1
	38.4%	40.0%	43.0%

BOARD OF DIRECTORS

Harry J. Saal
Chairman of the Board
President and Chief Executive Officer

Leonard J. Shustek
Executive Vice President, Secretary

Michael C. Child[1]
Partner, TA Associates

Gregory M. Gallo[1]
Member, Ware & Freidenrich

Laurence R. Hootnick[1]
Senior Vice President, Intel Corporation

[1]Member of Audit Committee

OFFICERS

Harry J. Saal
Chairman of the Board
President and Chief Executive Officer, Director

Roger C. Ferguson
Chief Operating Officer, Chief Financial Officer

Leonard J. Shustek
Executive Vice President, Research and Development, Secretary, Director

George E. Comstock
Vice President, Business Development

Morey R. Schapira
Vice President, Sales

Legal Counsel

Ware & Freidenrich
Palo Alto, CA 94301

Independent Public Accountants

Arthur Andersen & Co.
San Jose, CA 95110

Inquiries Concerning Network General

If you have questions concerning Network General's operations, recent results, or historical performance, or if you wish to receive Network General's 1990 Annual Report, 1990 Form 10-K, or press releases, all of which are available without charge, please contact:

Investor Relations
Network General Corporation
4200 Bohannon Drive
Menlo Park, CA 94025
415-688-2700

Inquiries Concerning the Stock

If you have questions concerning stock certificates, change of address, consolidation of accounts, transfer of ownership, or other stock account matters, please contact Network General's stock transfer agent:

Bank of America
Stock Transfer Services
P.O. Box 37002
Dept. 9527
San Francisco, CA 94137
415-624-4100

Common Stock

Network General's common stock is traded on the NASDAQ National Market System under the symbol NETG. As of June 1, 1990, there were 176 stockholders of record.

The following table shows the high and low closing sales prices for the Company's common stock as reported by NASDAQ for the periods indicated.

Period	High	Low
4th Quarter 1989		
(from February 2, 1989)	$ 12.25	$ 9.00
1st Quarter 1990	13.63	10.50
2nd Quarter 1990	20.50	13.00
3rd Quarter 1990	21.50	16.38
4th Quarter 1990	27.25	18.75

Dividend Information

Network General has never declared cash dividends and presently intends to continue this policy.

Network
General
Corporation

1
9
9
0

Network General

Network General Corporation, 4200 Bohannon Drive, Menlo Park, CA 94025 415-688-2700